

**Letter Report: The Misclassification of
Erroneous Refunds Has Caused Some
Taxpayers to Be Treated Unfairly and Actual
Inventories to Be Understated**

September 2001

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 13, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn

FROM: (for) Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report – The Misclassification of Erroneous Refunds
Has Caused Some Taxpayers to Be Treated Unfairly and Actual
Inventories to Be Understated

This report presents the results of our review to determine if the Internal Revenue Service (IRS) correctly identified and classified non-rebate erroneous refunds for individual taxpayers. In summary, we found the IRS used appropriate collection procedures to recover erroneous refunds that were correctly identified and classified. However, our statistical sample also determined that the IRS' inventory of non-rebate erroneous refunds was understated by 40 percent.

We recommended the IRS ensure that employees in applicable functional areas are aware of and use the proper classification procedures for non-rebate erroneous refunds. We also recommended the IRS implement guidelines to identify non-rebate erroneous refunds voluntarily returned by taxpayers and ensure that they are accurately counted as refunds erroneously issued.

The IRS agreed that it should classify erroneous refunds more accurately and that preventing improper refunds should be a priority. However, it did not agree with our second recommendation (that it establish a counting mechanism for erroneous refunds returned by the taxpayer) and believed that it can serve taxpayers better by directing efforts at preventing erroneous refunds. While we agree that the prevention of improper refunds is an important use of direct resources, we also believe an accurate accounting of improper refunds is paramount to ensuring that appropriate preventive efforts are fully explored. Management's comments have been incorporated into the report, where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or

M. Susan Boehmer, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

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Objective and Scope

The overall objective of this review was to determine if the IRS correctly identified and classified non-rebate erroneous refunds for individual taxpayers.

The overall objective of this review was to determine if the Internal Revenue Service (IRS) correctly identified and classified non-rebate erroneous refunds for individual taxpayers. The review was included in our Fiscal Year (FY) 2001 audit plan because the IRS identified non-rebate erroneous refunds as a material weakness for FY 2000.¹

We performed audit work at the Austin Submission Processing Center and Customer Service Site from January through March 2001. To accomplish our objective and to test whether proper collection action was taken based on the IRS' classification of erroneous refunds, we:

- Statistically sampled and analyzed 443 individual taxpayers where a non-rebate erroneous refund may have been issued.²
- Selected and analyzed a judgmental sample of 150 non-rebate and rebate erroneous refunds from current Accounting and Examination case inventories during January 2001.³

This audit was performed in accordance with *Government Auditing Standards*.

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

¹ Included in the IRS' annual report for FY 2000 Federal Managers' Financial Integrity Act (FMFIA).

² See Appendix IV.

³ This judgmental sample was randomly selected from files locally maintained in the IRS Accounting and Examination work areas.

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Background

Non-rebate erroneous refunds usually result from clerical mistakes made by the IRS and do not involve a change in the tax due.

Non-rebate erroneous refunds usually result from clerical mistakes made by the IRS and do not involve a change in the amount of tax due. In a 1998 study, the IRS found that 78 percent of non-rebate erroneous refunds were caused by misapplied payments that were incorrectly credited to the wrong taxpayer or were credited to the wrong tax year. For example, if a taxpayer sends a payment and the IRS mistakenly credits another taxpayer, an erroneous refund may be issued to the wrong taxpayer. Also, if the IRS credits the payment to the correct taxpayer, but to the wrong tax year, the payment may be erroneously refunded. Such refunds are called “non-rebate” erroneous refunds. The IRS reported that 22,957 non-rebate erroneous refunds totaling over \$31 million were issued from January through December 1999.

Taxpayers that receive a non-rebate erroneous refund receive a letter requesting the refund back. However, if the taxpayer chooses not to voluntarily repay the refund, the IRS has the option to file suit for repayment under certain circumstances. These refunds generally have a 2-year collection period.

Rebate erroneous refunds occur when a taxpayer or the IRS makes a mistake that causes the tax due to change.

Rebate erroneous refunds, on the other hand, occur when a taxpayer or the IRS makes a mistake that causes the tax due to change. For example, if a taxpayer makes a mistake on his/her return that lowers the tax due and the IRS does not correct it, an erroneous refund may be issued. If these refunds are not promptly returned, taxpayers could be subject to collection procedures that may include having a federal tax lien placed on their property. The collection period for rebate erroneous refunds is 10 years.

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Results

The misclassification of non-rebate erroneous refunds caused the actual non-rebate inventory to be understated and unfairly subjected many taxpayers to standard IRS collection actions.

We did not identify any instances where the IRS used inappropriate collection procedures when erroneous refunds were correctly identified and classified. However, the inventory of non-rebate erroneous refunds was significantly understated. Specifically the IRS:

- Identified the erroneous refund, but incorrectly classified the case 17 percent of the time. (These cases were classified as rebate erroneous refunds.) This misclassification caused the actual non-rebate inventory to be understated and unfairly subjected many taxpayers to standard IRS collection actions.
- Did not identify 23 percent of the non-rebate erroneous refunds. These refunds were voluntarily returned by taxpayers before the IRS discovered that a mistake had occurred. Unfortunately, the IRS does not have a method to count these refunds as erroneous causing the non-rebate inventory to be further understated.

The Internal Revenue Service Misclassified 17 Percent of the Non-Rebate Erroneous Refunds Issued in 2000

Many functional areas within the IRS are required by national guidelines to check for erroneous refunds. After a refund is identified, it is classified as rebate or non-rebate. Non-rebate erroneous refunds are forwarded to a centralized area where the case is monitored and controlled until resolved. In addition, the IRS has implemented new guidelines and now requires all service centers to report the number and dollar amount of non-rebate erroneous refunds on a quarterly basis.

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Appropriate collection action was used when the Internal Revenue Service correctly classified erroneous refunds

As noted, we did not identify any instances where the IRS used inappropriate collection procedures if erroneous refunds were correctly classified.⁴ To make this determination, we judgmentally reviewed 150 erroneous refunds at the IRS' Austin Submission Processing Center and Customer Service Site. This review included 50 non-rebate cases and 50 rebate cases where collection activity had ceased. We also reviewed 50 rebate cases where collection activity was currently underway.

However, inappropriate collection action occurred when the Internal Revenue Service misclassified erroneous refunds

We found that refunds to 75 individual taxpayers (17 percent of our sample) were non-rebate erroneous refunds that were misclassified.

To determine whether the IRS had correctly identified and classified non-rebate erroneous refunds, we statistically sampled 443 individual taxpayers from a nationwide population of 14,498 taxpayers who had misapplied payments. (See tables showing statistical results in Appendix V.)

Our analysis showed that in 256 instances the misapplied payments were non-rebate erroneous refunds where taxpayers were issued refund checks. Although the IRS did identify 153 of these cases, they misclassified 75 (17 percent) as rebate erroneous refunds.

The misclassification of these non-rebate erroneous refunds is attributable to misapplied payments that were either incorrectly credited to the wrong taxpayer or incorrectly credited to the wrong tax year. Although the IRS did identify these 75 refunds as being erroneous,

⁴ Although we did identify where the IRS had recently issued incorrect classification criteria, the criteria were corrected and reissued to all processing centers after we brought it to management's attention.

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Four of the 75 individual taxpayers whose refunds were misclassified have received notices of impending federal tax liens.

employees did not correctly follow classification procedures.

When non-rebate cases are misclassified, taxpayers may be subjected to unfair treatment through inappropriate collection action. For example, we found that 4 of these 75 taxpayers had received notices of impending federal tax liens. Examples of these notices are shown in Appendix VI.

Had these 75 refunds been properly classified, taxpayers would have received a letter requesting the erroneous refund be returned. This letter requests the refund back and informs the taxpayer that they could be charged interest and penalties if the amount is not repaid. However, it does not threaten any serious collection action such as filing a federal tax lien against the taxpayer. An example of this type of notice is shown in Appendix VII.

If we project the misclassified error rate of 17 percent to the sample's total population of 14,498 taxpayers, we estimate the non-rebate erroneous refund inventory was understated by 2,465⁵ individual taxpayers who may have been unfairly subjected to inappropriate collection action.

Recommendations

Since many functional areas are responsible for identifying erroneous refunds, the IRS should:

1. Ensure that employees in applicable functional areas are aware of and use the proper classification procedures for non-rebate erroneous refunds.

Management's Response: The IRS stated, "We will continue to educate employees by providing information, instruction, and job aids to help them prevent, detect, and properly classify erroneous refunds. We will send a memorandum to all operating divisions

⁵ The accuracy of this estimate is within a +/- 5 percent range of 2,342 to 2,588 individual taxpayers.

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for distribution to employees responsible for identifying erroneous refunds. The memorandum will stress the importance of following proper identification and classification procedures and will reference the Internal Revenue Manual.”

The Internal Revenue Service Did Not Account for 23 Percent of Refunds Voluntarily Returned by Taxpayers as Being Non-Rebate Erroneous Refunds

As earlier discussed, many functional areas within the IRS are required by national guidelines to check for erroneous refunds. If an erroneous refund is not identified by these areas, a notice will not be sent to taxpayers requesting that they return the refund. However, we found that many honest taxpayers received unexpected refunds and voluntarily returned them to the IRS prior to receiving any notice.

We found that refunds to 103 individual taxpayers (23 percent of our sample) were non-rebate erroneous refunds totaling over \$2.3 million that were voluntarily returned prior to receiving any collection notice from the IRS.

From our statistical sample we determined that 103 non-rebate erroneous refunds (23 percent) totaling over \$2.3 million were voluntarily returned by taxpayers prior to receiving any notice from the IRS. Although these refunds originated from a misapplied payment, they were not identified by the IRS as being erroneous after issuance or after being returned.⁶ (See tables showing statistical results in Appendix V.)

If we project the voluntarily returned error rate of 23 percent to the sample's total population of 14,498 taxpayers, we estimate the non-rebate erroneous refund inventory was understated by 3,335⁷ individual taxpayers that may have received a non-rebate erroneous refund.

⁶ The factors that caused the IRS not to initially identify these refunds as erroneous were beyond the scope of this review.

⁷ The accuracy of this estimate is within +/- 5 percent range of 3,168 to 3,502 individual taxpayers.

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Recommendation

2. The IRS should implement guidelines to identify non-rebate erroneous refunds voluntarily returned by taxpayers and ensure that they are accurately counted as refunds erroneously issued.

Management's Response: The IRS responded, "We disagree that we should implement this recommendation. Rather than expend resources to track this information, we believe we should direct resources and efforts to preventing errors that cause improper refunds."

Office of Audit Comment: While we agree that the prevention of improper refunds is an important use of direct resources, we also believe an accurate accounting of improper refunds is paramount to ensuring that appropriate preventive efforts are fully explored. For example, if improper refunds not previously detected as erroneous by the IRS are not accurately identified as improper when returned by taxpayers, it may lack sufficient information to quantify the volume of such returns and determine what preventive action is needed. Additionally, without an accurate method for identifying these refunds, the actual volume of improper refunds may be understated and inaccurately reported to stakeholders outside the IRS.

Conclusion

We estimate that the IRS did not identify 5,800 non-rebate erroneous refunds for individual taxpayers, causing the national volume for these refunds to be 40 percent understated in calendar year 2000. Of these, 17 percent were misclassified because IRS employees did not correctly follow existing procedures. Such misclassification, if not corrected, could result in taxpayers being treated unfairly by subjecting them to inappropriate collection action.

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Appendix I

Major Contributors to This Report

Walter E. Arrison, Assistant Inspector General for Audit (Wage and Investment Income
Programs)

Susan Boehmer, Director

Gary Young, Audit Manager

Tina Parmer, Senior Auditor

George Millard, Auditor

Bonnie Shanks, Auditor

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Appendix II

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Director, Compliance W:CP
Director, Compliance Services W:CP:CS
Director, Compliance Services, Austin W:CP:CS:AU
Director, Customer Account Services W:CAS
Director, Submission Processing Centers W:CAS:SP
Director, Submission Processing, Austin W:CAS:SP:AU
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison: Commissioner, Wage and Investment Division W

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Appendix III

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

Taxpayer rights - Potential - 2,465 individual taxpayers of the total population of 14,498 taxpayers may have been unfairly subjected to inappropriate collection action because the refunds were misclassified as “rebate” erroneous refunds. (see pages 4 and 5)

Methodology Used to Measure the Reported Benefit:

From our statistical sample of 443 individual taxpayers, we found that 75 cases (17 percent) had been misclassified as “rebate” erroneous refunds.

Type and Value of Outcome Measure:

Reliability of Information - Potential - The volume of non-rebate erroneous refunds, resulting from misapplied payments, was understated in calendar year 2000 by 5,800 individual taxpayers or 40 percent.¹ (see page 7)

Methodology Used to Measure the Reported Benefit:

- 2,465 (17 percent) of individual taxpayers were misclassified.
- 3,335 (23 percent) of individual taxpayers were voluntarily returned but not included in non-rebate erroneous refund inventories.

¹ Individual taxpayers included in this amount are also reported as part of another reported outcome measure

Sample Selection Methodology

We used the Individual Master File (IMF) Entity/Tax Database maintained at the Treasury Inspector General for Tax Administration's Central Site to identify all tax modules with a misapplied payment and a refund within the same module. We requested a computer extract of all 1999 tax modules nation-wide where an original payment had been reversed and a refund generated and posted to the IRS' IMF Master File between January 1 and December 31, 2000.

We received two data files containing 146,117 records as requested from archives maintained at the Central Site. We imported both files into an Access database and performed several queries to identify tax modules meeting a specified criteria and determined a total population of 14,498 taxpayers. Using this population, we selected our sample based on a 95 percent confidence level, and a +/- 5 percent precision rate. We then used the sample selection program from the Wage & Investment web site and randomly selected 443 cases for review.

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Appendix V

Statistical Results of Misapplied Payment Sample

Overall Sample Results

Total Sampled	Refunds Not Issued	Refunds Correctly Classified	Refunds Voluntarily Returned	Refunds Misclassified
443	187	78	103	75
100%	42%	18%	23%	17%

Analysis of 75 Misclassified Refunds

Sample Results	Totals	Refunds Due to the Wrong Tax Year Credited	Refunds Due to the Wrong Taxpayer Credited	Other
Actual	75	25	36	14
Projected +/- 5%	2465	822	1183	460

Analysis of 103 Refunds Voluntarily Returned

Sample Results	Totals	Refunds Due to the Wrong Tax Year Credited	Refunds Due to the Wrong Taxpayer Credited	Other
Actual	103	65	35	3
Projected +/- 5%	3335	2105	1133	97

Examples of Rebate Notices

Example of a 1st Notice For Cases Classified as Rebate Erroneous Refunds

Reminder

We show you still owe \$390.37

According to our records, you haven't paid all you owe for tax period 12-31-1999. To avoid additional penalty and interest, please pay the full amount you owe within 10 days from the date of this notice. We can file a Notice of Federal Tax Lien if your balance owed is not paid within 10 days from the date of this notice. If you already paid your balance in full or arranged for an installment agreement, please disregard this notice.

Example of a 2nd Notice For Cases Classified as Rebate Erroneous Refunds

IMPORTANT

Immediate action is required.

We previously wrote to you about your unpaid account, but you haven't contacted us about it. Penalties and interest on the unpaid balance are continuing to increase. Please pay the amount you owe within 10 days from the date of this notice. If you can't pay now, call us at the number shown below. You may be qualified for an installment agreement or payroll deduction agreement. We want to help you resolve this bill. However, if we don't hear from you, we will have no choice but to proceed with steps required to collect the amount you owe. If you already paid your balance in full or arranged for an installment agreement, please disregard this notice.

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Appendix VII

Examples of Non-Rebate Notices

1st Example of a Notice for Cases Classified as Non-Rebate Erroneous Refunds

We incorrectly applied a payment of \$500.00 to the above account. Because we should have applied this payment to a different account, the above tax period appeared to be overpaid and we sent you a refund. The check included interest of \$20.00. We corrected the error.

If you have cashed the check, please send your personal check or money order to repay the amount of refund.

2nd Example of a Notice for Cases Classified as Non-Rebate Erroneous Refunds

We incorrectly applied a payment of \$500.00 to the above account. Because we should have applied this payment to a different account, the above tax period appeared to be over paid and we sent you a refund. We corrected the error.

We won't charge interest if you repay the full amount of the check by 5-31-1999. Please return your check or money order with a copy of this letter to ensure the proper crediting of your repayment.

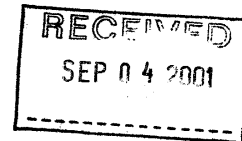
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Appendix VIII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308



AUG 31 2001

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM:

John M. Dalrymple
John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT:

Draft Letter Report – The Misclassification of Erroneous Refunds Has Caused Some Taxpayers to Be Treated Unfairly and Actual Inventories to Be Understated (Audit No. 200140021)

I reviewed your draft report and agree we should classify erroneous refunds more accurately. I believe preventing improper refunds, whether caused by taxpayer or IRS error, should be our priority. I also agree that proper classification benefits the customer and the Service. I differ, however, with the recommendation that we establish a counting mechanism for erroneous refunds returned by taxpayers. I believe we can serve our customers better by directing our efforts at preventing errors that cause improper refunds. The method outlined in Attachment III of the report is reasonable, and I agree with the benefits as reported.

Our comments on your recommendations follow:

RECOMMENDATION 1

Ensure that employees in applicable functional areas are aware of and use the proper classification procedures for non-rebate erroneous refunds.

ASSESSMENT OF CAUSE

Employees in many functional areas within the IRS are responsible for identifying erroneous refunds. IRS employees did not correctly follow classification procedures.

CORRECTIVE ACTION

We will continue to educate employees by providing information, instruction, and job aids to help them prevent, detect, and properly classify erroneous refunds.

We will send a memorandum to all operating divisions for distribution to employees responsible for identifying erroneous refunds. The memorandum will stress the

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importance of following proper identification and classification procedures and will reference the Internal Revenue Manual.

IMPLEMENTATION DATE:

December 1, 2001

RESPONSIBLE OFFICIALS

Director, Accounts Management, Wage & Investment Division

Director, Customer Account Services, Wage and Investment Division

Commissioner, Wage & Investment Division

RECOMMENDATION 2

The IRS should implement guidelines to identify non-rebate erroneous refunds voluntarily returned by the taxpayers and ensure that they are accurately counted as refunds erroneously issued.

ASSESSMENT OF CAUSE

Many honest taxpayers who received unexpected refunds returned them to the IRS before receiving any notice.

CORRECTIVE ACTION

We disagree that we should implement this recommendation. Rather than expend resources to track this information, we believe we should direct resources and efforts to preventing errors that cause improper refunds.

If you have any questions, members of your staff may contact Ron Watson, Director, Customer Account Services, at 404-338-8910.